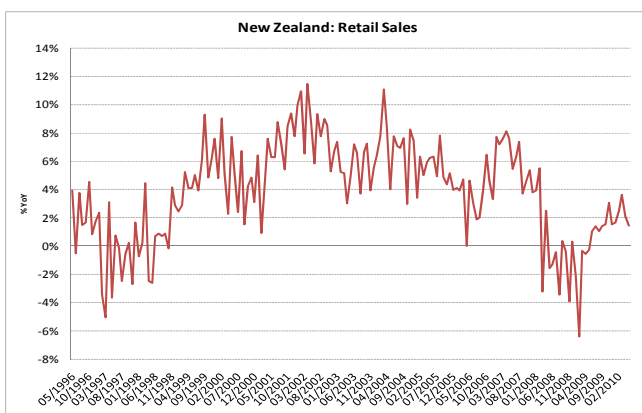


New Zealand: Rebalancing, Savings & Rates

It has been an interesting few days travelling around New Zealand. The economy is clearly “quiet” at a superficial level and even the tourist destinations seem to be simply moderately busy rather than hectic and most residents that we have encountered seem to view the recovery as having stalled rather than continued.

Within financial market circles, economic growth estimates are being pared back and there is much talk of a pause in the Reserve Bank’s programme of rate hikes. Certainly, those within the policymaking arena do acknowledge that although export sector revenues have been brighter than expected (principally as a result of stronger than expected agricultural export prices and a bounce back in the manufacturing sector), they also recognise that domestic demand trends have not lived up to expectations – retail trends have been soft and the housing market recovery seen late last year has clearly not endured.



In practice, we wonder just how much of a ‘recovery’ New Zealand experienced late last year and in the early part of this year. In

reality, the revival in retail spending that occurred six months ago was quite modest given the extent of the falls that had taken place previously and the revival such as it was seems not to have involved much in the way of new borrowing by what has been a traditionally cash flow negative sector.



Consequently, we suspect that unlike their Northern Hemisphere, or even Australian, counterparts, New Zealand households did not enter into the low-savings-driven consumer recovery that affected much of the global economy in the early part of this year. Elsewhere, we also find that even the revival in agricultural exports appears to have been the result of price rather than volume factors that may now be reversing.

These factors, together with the apparently aborted recovery in the housing market, do seem to suggest little need for higher domestic interest rates at present and this is now becoming something of a consensus view, particularly given the still high – and clearly overvalued – exchange rate at present and the widely advertised plans for a modest fiscal tightening over the next few years.

We wonder, however, whether the New Zealand economic story is quite so straight forward. For example, the housing market is clearly still weak and although credit and activity trends did improve slightly earlier this year we might suggest that this was simply

the result of the market 'un-jamming' and a volume of pent up sales and purchases associated with the albeit still depressed levels of labour mobility and migration taking place.

In practice, we suspect that the housing market remains characterised by relatively few 'discretionary' buyers and also relatively few sellers, since many households are taking advantage of the low interest rate environment and its associated 'low carry cost' for mortgagees by continuing to warehouse even investment properties in anticipation of an eventual recovery in both prices and volumes.

Households and property investment companies seem to be attempting to ride out the storm in anticipation of better times ahead – a form of behaviour that suggests to us that although residents may not be prepared to expand their balance sheets in this area at present, the pro-property investment psyche that has existed in the economy for the last few decades or more remains deeply entrenched. In short, one is left with the impression that although the housing market is weak at present, there is still a feeling that it will ultimately bounce back and once again provide a 'cash point' for home owners and therefore a springboard to a new round of low-saving / debt financed consumption.

For the RBNZ, this potential for a return to household deficit spending remains a factor in their interest rate deliberations.

Similarly, although fiscal policy is being restructured and is expected to tighten, much of the tightening requires cuts in government spending, many of which are hoped to be achieved through attrition rather than positive action. Experience elsewhere has suggested that this is not always easy to achieve and so the exact stance of fiscal policy and the impact of the shift in direct to indirect taxation included within the government's plans are difficult to quantify in terms of their likely overall effect on growth and savings behaviour.

Therefore, at present, it would appear that the private sector (principally the household sector) and the state sector are moving towards positive financial balances and higher implied savings, something that the authorities can welcome in the post Greek Crisis world. Indeed, it is clear that much thought and mathematics has been devoted into the subject of how New Zealand can stabilise its levels of public and external debt so as to not leave itself open to a foreign investment 'strike' that destabilises the currency, the local debt markets and, most of all, the domestic banking system that is both primarily foreign owned and substantially foreign-financed. Any souring of investor attitudes to New Zealand could result in an instant and painful domestic credit crunch.



To our mind, New Zealand is clearly not in Greece's position but the high level of foreign debt in the local banking system is clearly a fragility in the economy and it is one that both the Treasury and the Reserve Bank are aware of and that they wish to combat by ensuring that New Zealand's economy develops a higher propensity to save its incomes and therefore to run smaller current account deficits or even surpluses over the longer term. The current account balance in the international Balance of Payments figures is the mirror image of the country's savings balance and hence the more residents save, the better will be the current account balance and the lower the country's external debt level. The RBNZ apparently sees one of its medium term objectives as encouraging more savings and interest rate policies and indeed

housing market policies play some part in this aim, as of course does fiscal policy.

This desire to promote saving at the expense of consumption (and implicitly housing investment) would also fit into the authorities' long run desire to see a rebalancing of the economy towards more traded goods and service production and away from non-traded goods production. Over the last few quarters, the opposite has of course occurred as exports have outperformed the domestic economy but few in officialdom see this as necessarily the beginning of a new trend, unless the policy environment continues to steer the economy in this direction. Key to achieving this aim is not just the level of current interest rates but also people's expectations for interest rates in the future – in particular the RBNZ does not want people to come to believe that interest rates will always be low and that bad investments can always be 'warehoused' at low carry costs.

One factor that is apparent from the government's plans is that the changes in GST sales taxes and green levies will push the inflation rate towards a peak of over 5% by year end, an event that, like all central banks, the RBNZ fears could become factor in wage setting behaviour and long term inflation expectations in an economy that is still working close to its trend rate of output despite last year's recession (the recession occurred from an overheated level).

Finally, during previous visits we had been made aware of the central bank's fears for the now heavily indebted farm sector. Although the majority of the 'excess leverage' is apparently concentrated in relatively few farm owners, these borrowers nevertheless represent a risk to the financial system and a threat to the economy as a whole. However, while these potential fragilities remain and there is always a fear that the farm sector's foreign creditors may one day 'pull the plug' on the sector, actual cash flow trends at present are adequate and this remains a potential rather than actual problem for the economy. Consequently, even this 'problem' remains an equivocal one for the central bank and its policy deliberations.

The conclusions that we draw from this analysis is not that New Zealand's economy is only growing slowly, if at all (which is plain), but rather that the RBNZ's longer term policy framework does not suggest that the central bank will necessarily pause in its rate hike programme. The rate hikes may be moderated and the central bank is clearly mindful of both the high level of the NZD and a possible deceleration in growth amongst its trading partners next year but its longer term policy framework will probably lead it to attempting to be a little less predictable than it has in the past and probably a little more hawkish than the market expects. In the post Greece world, policymakers are no longer focused solely on near term growth outturns; longer term financial stability has moved up the policy agenda it seems. Therefore, we suspect that the RBNZ will continue with its tightening bias until if and when the global double dip hypothesis is confirmed.

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Andrew's 2010 New Zealand presentation dates:

Winter Series	
24 August 12.30pm	Queenstown, lunch Cophorne Hotel
26 August 11.25am	Convention Centre Christchurch
Workplace Savings Forum	

For further details of presentations, please contact helen_mckenzie@tyndall.co.nz
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